

Erkki Liikanen: Is there a Finnish or Nordic Model? Can the Nordic Model rescue European values?

Remarks by Mr Erkki Liikanen, Governor of the Bank of Finland, at the Belgian Financial Forum, Brussels, 15 February 2008.

The [slides](#) (ppt) accompanying the speech can be found on the Bank of Finland's website.

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1. Introduction

Are there broadly-shared, characteristically European values? Most tend to agree that there are, such as social cohesion and solidarity.

Market economy has turned out to be the best system to create growth and raise the standard of living. Still there is also a wide-spread recognition that market forces can sometimes result in outcomes that are not in keeping with these values. Consequently, a vast majority of Europeans share the conviction that the state should promote equality of opportunity and come to the assistance of those most in need.

Nevertheless, there is no such thing as "the Single European Social Model". Owing to historical reasons and differences in local circumstances, these models differ considerably across Europe.

Some argue that, while laudable, the European values are no longer compatible with the harsh realities of the modern world and the social models need urgent reform. The modern world is characterized by ever intensifying competition brought up by globalization. At same time the ageing of population sets pressure on the labour market and public finances.

So, is the distinctly European combination of social values and economic policies an issue of the past, a promise that can no longer be fulfilled? Or is it possible to reconcile it with the forces of globalization and demographic change without stifling economic dynamism? Should it be seen as an asset or as a liability?

Indeed, we can find examples that show how some features of a traditional welfare state have acted as a drag on economic growth. On the other hand the Nordic countries provide for many an example on how collective risk sharing has promoted opening of economies and adjusting to globalisation.

2. Variety of European social models

Your compatriot, a Belgian professor André Sapir (2005) has divided the EU-15 countries into four groups based on their efficiency and equity. Efficiency here refers to sufficient incentive to work so that employment rates get relatively high. Equity¹ in these models means keeping the risk of poverty relatively low. Although all these models share some common European values, there are some basic differences between them.

The Mediterranean Model has rather low coverage of unemployment benefits increasing risk of poverty. On the other hand strict employment protection regulations have contributed to low levels of employment. So Professor Sapir classifies these countries to the group with "low equity and low efficiency". Social spending is much concentrated on old-age pensions. Early retirement provisions are an important part of the social welfare systems.

¹ Sapir included in his Nordic model Denmark, Finland, Sweden and the Netherlands. The two non-EU Nordic countries, Norway and Iceland, also fit the description of the Nordic model. See Sapir, André (2005): "Globalisation and the Reform of European Social Models". Bruegel Policy Brief, Issue 2005/1.

In the Continental Model unemployment benefits are generous and the legislation on employment protection is relatively strict (high equity and low efficiency). The social welfare system is largely based on insurance-based benefits and old-age pensions.

The Anglo-Saxon Model includes relatively good unemployment insurance but weak employment protection (low equity and high efficiency). Contrary to the American system, these countries provide relatively large social assistance of the last resort. Income transfers are primarily oriented to people in working age and active measures to help the unemployed to get jobs are important. Schemes that link access to benefits to regular employment are used.

In the Nordic Model unemployment benefits are generous and comprehensive. The employment protection legislation is not as strict as in many continental countries (high equity and high efficiency). The Nordic countries offer good social protection and universal welfare provision.

In reality, the groups are far from being homogenous inside. Also the Nordic economies differ from each other for instance in their industrial structure. Neither are their labour market or welfare policies uniform.

But still, the Nordic countries share some characteristic features that constitute the essence of the Nordic Model. A recent study of six Nordic economists² has come to the conclusion that the Nordic countries tend to create a cluster of their own along many dimensions. The basis of the Nordic model is a combination of collective risk sharing and openness to globalisation.

3. Globalisation and population ageing – the main challenges for social models

I will look at two challenges that are of vital importance: globalization and population ageing. The responses to these challenges will have an important bearing on the future of European social models.

Globalization and rapid technological change calling for risk sharing

Globalization has underpinned an exceptionally long, strong and broad-based economic expansion. The strong growth in emerging market and also developing countries is reducing the number of people living in extreme poverty. The developing countries have grown faster than developed economies and so there has been a catching up during the last few years. These are most welcome developments.

Europe has also benefited greatly from robust global growth. But as we know, the risks and the benefits of globalization typically are unequally shared between regions, sectors, firms and individuals.

Globalization and rapid development of technology are separate but closely related phenomena. Globalization reduces barriers and implies restructuring and relocation of economic activities to take advantage of new technologies and comparative advantages.

This implies accelerated change and a less predictable operating environment. In such an environment, stability-oriented macroeconomic policies are particularly essential as they reduce the overall uncertainty faced by consumers and companies alike.

² Andersen, T.M.; Holmström, B.; Honkapohja, S.; Korkman, S.; Söderström, H.T. and Vartiainen, J. (2007): "The Nordic Model, Embracing globalisation and sharing risks". The Research Institute of the Finnish Economy (ETLA).

Globalisation and technological innovation threaten the status quo and raise calls for protectionism. Such calls must be resisted. Shielding companies from competition undermines their long-term viability. Thus the long-term success of European companies calls for more, not less, competition. Also, protectionism will not stop technological innovation. History teaches us that a stubborn refusal to accept technological advances is not a viable option.

Having said this, we must recognize that there are challenges associated with globalization. Two problems stand out. *First*, globalisation brings with it painful economic dislocation, and many people lose their jobs. *Second*, technological advances tend to lead to higher dispersion of income.

Governments can and should play an active role in easing the pain of dislocation. Social safety nets are needed to cushion economic dislocation in a rapidly changing world. However, they must not support unviable structures and practices. The safety nets should not lock people but encourage them to adapt and seek new opportunities.

There has been a lot of debate whether a European social model or models are able to reconcile the benefits and risks of globalisation and find a positive trade-off between equality and efficiency.

The Nordic model has attracted considerable interest because it seems to be able to combine *a high level of social protection and relatively equal income distribution with high economic dynamism*.

The individuals are not usually able to insure themselves against the risk of losing their job or finding their skills outdated. The above mentioned Nordic group of economists³ argue that it is the collective risk sharing by the welfare state and the labour market that facilitates acceptance of globalisation.

The traditional institutional system of the Nordic labour market has based on coordinated negotiations between strong partners and supporting policies by the government. The group argues that this may be seen as a way of offering security to workers without drawbacks of tight legislative labour market regulation. The risk sharing has made it possible to combine the flexibility required by open markets with the security that workers and citizens want to have.

According to Professor Dani Rodrik (1998)⁴ the positive correlation between openness and the size of the public sector means that external openness increases risks and so the demand for the insurance and security that the welfare state can offer.

Still not to make the issue too easy, there are many concrete cases also in our country which show that the closure of a factory which is an important employer in a region, is a painful process.

The economic consequences of population ageing are fundamental

Ageing of the population will be an increasing problem in most industrialised countries during the next decades. In many countries the birth rate was high in the first decades after the Second World War. Later the birth rate lowered strongly, which causes the big difference in the size of age cohorts.

³ Andersen, T.M.; Holmström, B.; Honkapohja, S.; Korkman, S.; Söderström, H.T. and Vartiainen, J. (2007): "The Nordic Model, Embracing globalisation and sharing risks". The Research Institute of the Finnish Economy (ETLA).

⁴ Rodrik, D. (1998): "Why do more open economies have bigger governments?". Journal of Political Economy 105 (6), October 1998.

In Europe, Finland is the first country to face the steep ageing due to the baby boom generation born in 1945–1949. In most countries the baby boom was later and it was longer.

So the impact of aging is not a theoretical question but a reality for Finnish policymakers today. The demographic change will be further strengthened by the increasing life expectancy.

As you can see from the figure, the cohort of 60-64 years outnumbered the cohort of 20-24 years last year. The working age population starts to decline soon. There will be increasing shortage of labour force in many sectors – especially in services such as health and elderly care. The ageing affects not only on labour supply but also on the demand for services.

The 2005 pension reform in Finland was designed to ease ageing pressures on the sustainability of the pension system and labour markets.

The increasing old-age population together with the increasing demand for welfare and health services set also a pressure on the public economy. The Nordic social model is based on the idea that people are in different phases of their life cycle net beneficiaries and net contributors of the social system.

When the number of net contributors decreases in relation to the number of net beneficiaries this causes a serious financing problem. At same time the room for higher taxation is limited because of an already heavy tax burden, increasing tax competition and declining trend of GDP growth.

It would be also politically unsustainable if the contributing population felt that the welfare society means for them only costs but not benefits. Public services need to provide a good match with the preferences of a median voter. Without such a match, the funding base of the public sector (taxes) will inevitably start to erode. This could lead to a vicious circle that would be difficult to reverse. This underlines the need to keep the welfare services universal (open to all) and high quality. A good example of this is the school system.

When the labour contribution to growth will be small or even negative, the role of productivity will grow in weight. Even though it is difficult to measure productivity in the public sector, in aggregate terms it appears to be lower than in the rest of the economy and in particular in the open sector (Baumol effect), and grows more slowly if at all.

Still I am convinced that there are ways to increase productivity in the public services, too. The use of information technology and parallel re-engineering of work processes and organisations, as well as incentive based wage systems and benchmarking with best practices can bring improvements also in the productivity in the public sector.

One way is to expose part of the public services to private competition, when provision of public services does not require that they are all produced by public sector. However, the main question is, whether the economic growth will be strong enough to bear the heavy cost burden that the ageing causes. The smaller number of working age population must be able to bake a cake big enough to feed the increasing share of population that is outside the labour force.

4. Meeting the challenges – the Nordic model and Finnish experiences

The Nordic model includes a large government sector, high tax rates, generous social protection and compressed wage structures. However, the standard economics text-books teach us that such features generally distort incentives for efficient resource allocation.

This notwithstanding, during the past decade the Nordic (EU) countries have achieved higher growth rates than the advanced European countries on average. The Nordics have been able to achieve high employment combined with macroeconomic stability.

Part of the strong economic performance in the Nordic countries can also be attributed to luck – both bad and good. As for the bad luck, there was a serious sharp economic downturn in Finland and Sweden in the early 1990s. Seen afterwards, it was to some extent a blessing in disguise. This is because it gave impetus to structural reforms and disciplined macroeconomic policies that ushered in a strong recovery from the recessions.

As for the good luck, both Finland and Sweden have been lucky to have been in the vanguard of the mobile phone technology during its explosive growth phase.

During the last 10 years the average economic growth in the Nordic countries has been stronger than in the EU-15 in average. Does the good economic performance of Nordic countries mean that the economics textbooks are wrong and that incentives and markets do not really matter that much? The answer is a resounding no.

In fact, the strong macroeconomic performance in the Nordic countries owes a lot to policies that are well in line with recommendations of mainstream economics.⁵

So, does the Nordic model offer a way to reconcile the European ideals with the demands of the global economy? Are there some practises and solutions in the Nordic model that could be applied in other European countries? To answer this question, we need to look more closely at the Nordic experience.

- *Openness to competition.* Substantial product market deregulation has helped underpin economic growth in the Nordic countries. This deregulation took place earlier than in most other European countries and the level of product market regulation in the Nordics is low by European standards. The collective risk sharing included in the Nordic social model has decreased the political resistance to such development. It has got easier for people to accept liberalisation of trade and globalisation when they feel they have some personal shelter against income fall caused by unemployment or other reason.
- *Sound macroeconomic policies.* Public finances in the Nordics are in better shape than in most other European countries although the welfare services are generous. Their debt ratio is low and annual budgets are on the surplus. The price of this has been the high taxation. But also disciplined fiscal policy has contributed to the fiscal balance and created an environment in which consumers and businesses can plan for a longer term. Sound monetary policies have also been instrumental in supporting growth.
- *Strong and transparent institutional framework.* An institutional environment in which contracts can be enforced and property rights can be established promotes economic growth. Increasingly, all European countries share such an institutional environment. However, The Transparency International rates the Nordic countries in the top ten at to the transparency and integrity of their public sector.⁶

5. The importance of education and research and development

So, good policies, sound institutions and some luck go far in explaining the strong performance of the Nordic countries. However, by digging a bit deeper, we can see also the

⁵ For a more comprehensive assessment of the strengths and weaknesses of the "Scandinavian Model", see e.g. Chapter 4 in the EEAG Report on the European Economy 2007, prepared by the European Economic Advisory Group at CESifo.

⁶ For instance, Denmark and Finland shared the top ranking, and all the Nordic model countries were in the top ten, in Transparency International's 2007 Corruption Perception Index that looks at perceptions of public sector corruption in 180 countries and territories. See: http://www.transparency.org/policy_research/surveys_indices/cpi/2007

crucial role of education and investments in R&D. The Nordic countries share a long-tradition of emphasising the importance of education.

Nordic countries, particularly Sweden and Finland have high public and private spending on Research and Development, comparable with that of the United States. The particular character here is a close partnership between public and private sector. This has also fostered innovation in the environment of an open economy.

OECD has recently publicized a third so called PISA-study. Finland has performed well in all three studies. It was emphasized in the study that good performance in Finland did not differ between the regions and correlated less with family background than in most countries. In a small country it is important to get all the talent resources in efficient use. The education is here the main tool.

Nowadays, the share of the working age population with upper-secondary education, as well as tertiary education, is considerably higher in the Nordic countries than in the other EU countries on average. Moreover, the participation rates for non-formal job-related continuing education and training are exceptionally high in the Nordic countries.⁷

The Nordic economies have benefited from a well-educated labour force. The skilled labour force has contributed to a rapid diffusion of information and communication technologies, thus contributing to favourable productivity developments.

The causality between democracy and prosperity may run both ways. However, a well-functioning democracy becomes even more vital to economic growth as a country becomes more prosperous. This is because the richer countries need to rely primarily on "smart growth", that is, increasing total factor productivity through innovation and technological change, while the poorer ones can grow robustly for long periods merely by imitating more advanced countries and adding more inputs of labor and capital.⁸

6. Conclusions

So, what is the answer to the question that I posed at the beginning, i.e., is a social model based on European values an asset or a liability? As is often the case in real life, the answer is: "it depends".

In a rapidly changing environment any static model is likely to become a liability. Indeed, economic systems are so complicated that no single policy prescription can ensure rapid and sustainable growth over the long run. Therefore, it would be helpful to shift the focus from copying particular "models" to analysing what structures are needed to support successful and adaptable approaches.

I have attempted to do so by examining the experience of the Nordic countries, especially Finland. This experience suggests that it is possible – even not without pain – to combine economic dynamism with a system that is consistent with the core European values. The sound macroeconomic policies and social insurance typical for Nordic labour market decrease the need for stringent employment protection legislation.

What lessons could we draw from the Nordic experience? Sound macroeconomic policies are fundamental as well as structural reforms that promote competition. And we should not underestimate the role of high-quality public institutions, especially in education and

⁷ See e.g., OECD (2007), *Education at a Glance*, Paris.

⁸ For an interesting discussion of determinants of growth in countries at different levels of development, see Baumol, W.J., Litan, R.E. and Schramm, C.J. (2007) "Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity", Yale University Press, or Eichengreen, Barry and Leblang, David (2006) "Democracy and globalization", NBER Working Paper 12450.

research, in supporting both economic growth and a democracy that is open to new ideas and change.

Going forward, European values of solidarity and social cohesion will be tested by centrifugal forces arising from globalization, rapid technological advances and population ageing. Ensuring that these values are truly reflected in European social models will require many painful decisions, and we must be mindful of the dangers of populism.

This calls for a frank and honest political discourse that recognizes the benefits and downsides of globalization and other forces that shape the future. This, combined with a well-educated electorate, and a culture of transparency provide a powerful antidote against populist policies.

To survive and thrive in the global competition, Europe must not be focused on preserving structures; it needs to embrace change in order to preserve its core values. This requires innovation not only in business but also in social models.